Best Practice:

How is Needham Addressing OPEB?

With many local officials struggling to understand and plan for looming liabilities related to other post-employment benefits (OPEB), we thought it would be beneficial to explore the approach that the Town of Needham has taken to address these future obligations. A community that fails to act on its OPEB liabilities runs the risk that future health insurance expenses will become so large that they eventually overwhelm other budget priorities and have a detrimental impact on municipal services.

Background

For those that may not be familiar with this topic, other post-employment benefits refer to benefits other than pensions that employees receive after they retire. By far, the most significant of these is health insurance, but may also include life insurance, dental or other benefits paid after an employee's retirement. In 2004, the Governmental Accounting Standards Board (GASB) issued directives concerning how these liabilities must be presented in a municipality's financial statements going forward (Pronouncements 43 and 45).

Similar to an employee's pension benefits, OPEB are earned during the employee's active working career, but are not actually paid until after the employee retires. GASB directed that these future costs no longer be accounted for on a pay-as-you-go basis, but rather these liabilities must be recognized as they are earned or accrue. In other words, employees earn the right to receive health insurance and other benefits upon retirement incrementally over their active working career. Therefore, on an accrual basis, the annual cost of an employee's health insurance includes both the municipal share of the actual premium paid on the employee's behalf plus a portion of the projected post-retirement benefit earned in the current accounting period.

These projections are done by actuaries who look at several variables to estimate these future costs. These variables include a projected rate of inflation for future medical costs, assumptions about employee turnover, age at retirement, Medicare eligibility, election rates for various plans at retirement, and mortality. Factored in as well are the respective cost sharing agreements for splitting benefit costs between the municipality and retirees. To attribute these future costs to current accounting periods, it is necessary to calculate a present value of these future benefits using a discount rate. As we will discuss later, the discount rate has a tremendous impact on the calculation of OPEB liabilities.

The important estimates that emerge from an actuarial analysis include the total present value of future OPEB benefits and the required contribution that must be appropriated annually to address this liability over multiple years. The projected cost of future benefits discounted to a present value is referred to as the actuarial accrued liability (AAL). This amount is then attributed to the current and prior fiscal years based on when these benefits were earned. The amount of the AAL is reduced in cases where there are OPEB reserves set aside. The annual required contribution (or ARC) is the portion of projected benefits earned in or attributable to the current fiscal year (normal cost), plus an additional amount necessary to amortize the unfunded actuarial accrued liability for prior years. The amortization period cannot be more than 30 years.

<u>Needham's Experience</u>

Well before the formal issuance of GASB's OPEB pronouncements, Needham was among the first municipalities in the state to recognize the need to take action regarding OPEB liabilities. In January of 2002, the legislature approved the town's special act to establish a post retirement insurance liability trust fund. The act was modeled after similar legislation that had been approved earlier for Bedford.

An initial appropriation of $380,000 was achieved through savings that arose in the contributory pension appropriation and a favorable actuarial analysis of the retirement system. An additional $380,000 was appropriated to the trust fund in each subsequent year from FY2002 through FY2007. In FY2005, when the town converted its health insurance coverage to the West Suburban Health Group, it saved more than $1 million. Half of the savings or $500,000 was also appropriated to the trust fund.

By 2007, with a modest amount set aside in the trust, the town reviewed its "pay as you go" retiree health insurance appropriation in relation to its annual required contribution (ARC). It found that with the retiree health insurance appropriation, plus the annual set aside of $380,000, that the town was only about $120,000 away from appropriating its full ARC. The important message here is that retiree health costs can be paid as part of the annual appropriation of the ARC, with the difference between the ARC and retiree health costs reserved in the trust for future liabilities.

Through a second special act approved by the legislature in 2008, the town amended the investment standard for assets in the trust from investments that are legal for savings banks to the more flexible prudent investor standard. This change opened the door to more lucrative investment opportunities and put the fund on equal footing with the investments allowed for a pension fund. It also made it far more likely that the town could achieve its targeted rate of return on these investments of 8 percent.

As noted earlier, the discount rate used to calculate the present value of future OPEB costs plays a significant role in the size of the liability. For communities contributing their full ARC, GASB allows a discount rate of 8 percent based on the estimated long-term yield on plan investments needed to pay future benefits. For plans that are pay-as-you-go and not funded at all, a discount rate of 4 percent or less is required, reflective of the much lower rate of return on general assets. For partially funded plans, a blended discount rate can be used.

To illustrate the importance of this discount/investment rate in these actuarial calculations, Needham's unfunded actuarial accrued liability as of July 1, 2007 was $76.4 million using a 4 percent discount rate and it dropped to $43.6 million with the use of an 8 percent discount rate.

<u>Investing with PRIT</u>

With the adoption of the prudent investor standard, Needham began analyzing its options for investments and investment advisory services. For many years, the town's pension assets had been invested with state pension assets in the Pension Reserves Investment Trust (PRIT). Through this longstanding relationship, town officials were aware that the PRIT fund had an average annual rate of return of more than 9.6 percent since its inception in 1985. At the time, however, there was no legal mechanism to combine the town's OPEB funds with its pension assets or otherwise invest these funds with PRIT, so the town was forced to invest its OPEB trust on its own.

With the approval of outside sections 50 and 57 of the FY2012 state budget (Chapter 68 of the Acts of 2011), cities, towns, districts, counties and municipal lighting plants were authorized to invest their OPEB trusts with PRIT. To do so, entities must accept MGL c.32B, §20 to establish a trust fund and seek approval from the Board of Trustees of the state's Health Care Security Trust (HCST) to invest in the State Retiree Benefits Trust Fund (SRBTF, MGL c.32A, §24). The SRBTF is invested in the PRIT Fund's General Allocation Account (GAA), also known as the PRIT Core Fund. This fund contains about $58 billion in state and local pension assets, as well as the state's OPEB assets. For communities like Needham with existing OPEB trusts authorized by special act, similar permission to invest in PRIT was contained in an amendment to MGL c.32A, §24.

To receive approval from the HCST Board to invest in PRIT requires that a municipality submit several documents as part of the application process. This documentation includes evidence of adoption of MGL c.32B, §20 or special legislation, acknowledgement of investment risk and an investment agreement and a designation of a custodian. The custodian can be either the municipal treasurer or the HCST. If the treasurer is to be the custodian, the SRBTF should be identified as an authorized investment vehicle for the treasurer. Lastly, the Board requires indication of the commitment to fund these liabilities. The Board has set a minimum initial investment requirement of $250,000 and a non-binding goal for qualified governmental entities to reach $1,000,000 over three years.

Earlier this fiscal year, Needham liquidated its OPEB investments and transferred the resulting cash balance to PRIT. The town now has about $15 million in assets invested with PRIT, or roughly 20 percent of the total municipal OPEB assets invested with PRIT. Needham officials identified several factors that influenced their decision:

- The town's longstanding, successful relationship with PRIT to invest the town's pension assets provided a comfort level with moving OPEB funds to PRIT.
- Investing with PRIT eliminated the need for Needham to procure investment management services through the MGL c.30B procurement process.
- The PRIT fund is one of the best performing state pension funds in the country and serves as an excellent vehicle for attaining the town's targeted rate of return on OPEB investments.
- Professional investment management is provided at a lower cost due to economies of scale than the Town of Needham would have realized by going out on its own for the services.
- A highly diversified portfolio that makes use of investment vehicles not available to smaller investors (e.g., private equity, direct hedge funds, timber, and private real estate).
- PRIT understands the investments that are legal in MA where an outside investment advisor might not be aware of various prohibited investments.

Conclusion

Needham's experience provides several important takeaways for other cities and towns that might not be as far along with OPEB. Although GASB has not mandated a funding requirement for OPEB liabilities, it is important for municipalities to start saving for these costs as soon as possible. Through the adoption of MGL c.32B, §20, a community can establish an OPEB trust, use the prudent investor rule for trust assets and invest these funds with PRIT. Even if your community is not in the position to contribute the full ARC each year, modest and manageable contributions are better than nothing. Strategies to set aside one-time revenues, appropriation balances or other windfalls and appropriate them to the trust as available or identifying an appropriate recurring revenue stream can make a significant difference.

Once funding sources have been identified, it is important that these assets are invested with a long-term outlook similar to pension assets. A simple, low cost way to meet these long-term funding needs is to apply for authorization to invest these funds in the state's PRIT fund. The tremendous diversification of investments, the annual performance of this fund over time for pension assets and the similarities between the long-term investment horizons for pension and OPEB liabilities make the PRIT fund an excellent vehicle for the investment of OPEB trusts. For additional information about PRIT, please contact Paul Todisco, Senior Client Services Officer at 617-946-8423 or ptodesco@mapension.com.

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